DEDUCTING YOUR MORTGAGE INTEREST UNDER THE TAX CODE

One of the best justifications for owning a home, at least for financial reasons, is the tax savings that result from deducting mortgage interest. The deduction for mortgage interest stands as one of th e few remaining tax deductions for the typical middle class taxpayer. Despite the changes to the tax code over the past several years and the repeal and limitation of many non-housing itemized deductions, mortgage interest is still deductible on first and second mortgages and home equity lines of credit (with some limitations). Your mortgage interest deduction can be a good financial incentive to buy a home.

YOUR MORTGAGE INTEREST DEDUCTIONS

Under the current tax code, mortgage interest on first and second homes is generally deductible as long as these loans total less than $1.0 million, making home ownership one of the best ways to trim your tax bill.

Two Kinds of Debt

Under the current tax system, there are two different kinds of debt. Money you borrow to buy, build, or substantially improve your residence is called "**acquisition indebtedness**." Money you borrow against the equity in your home, or money you take out when you refinance your home for any reason except home improvement, is called "**equity indebtedness**."

When you borrowed the money is also important. Home loans taken out before October 14, 1987, are exempted from the new rules. You may fully deduct interest paid on these loans, regardless of their size or what you used them for. Any refinanced debt you incurred before October 14, 1987, is rolled into your total acquisition indebtedness. On loans made on or after October 14, 1987, you can deduct mortgage interest paid on **acquisition indebtedness up to a total of $1.0 million ($500,000 if married filing separately)**. This means you could buy a home for $250,000, a beach home for $200,000, and add a family room to your first house for another $100,000, and still have $450,000 to spend on these homes for further improvements before you reached your limit for interest deductibility. The $1.0 million is not cumulative. As you pay off a loan, you would add that amount to your total purchasing or improving up to two residences.

Your **equity indebtedness limit is $100,000 ($50,000 if married and filing separately) or the total of each home's fair market value (FMV) reduced (but not below zero) by the amount of its home acquisition debt and grandfathered debt.**

Example. You own one home that you bought in 1998. its FMV now is $110,000 and the current balance on your original mortgage (home acquisition debt) is $95,000. Bank M offers you a home mortgage loan of 125% of the FMV of the home less any outstanding mortgages or other liens. To consolidate some of your other debts, you take out a $42,500 home mortgage loan [(125% x $110,000) - $95,000] with Bank M. Your home equity debt is limited to $15,000, this is the smaller of:

1. $100,000, the maximum limit, or
2. $15,000, the amount that the FMV of $110,000 exceeds the amount of home acquisition debt of $95,000.

Interest on amounts over the home equity debt limit (such as the interest in the example above on $27,500 ($42,500 - $15,000) generally is treated as personal interest and is not deductible.

LOAN TYPE VARIES INTEREST DEDUCTION

As we've said, the mortgage interest tax deduction is one of the best financial reasons to buy a home. The amount of interest you pay over the life of your loan depends on what kind of mortgage you determine is best for you. You will be paying more interest on a 30 year loan then you would on a 15 year loan.

REFINANCING YOUR MORTGAGE

Many homeowners have taken advantage of lower interest rates by refinancing their mortgages. In the past, refinancing your mortgage has proved to be an excellent opportunity both to lower your interest rate and monthly payment and take equity out of your home.

When refinancing your mortgage, you will probably pay 3 percent to 6 percent of the loan amount in closing costs for surveys, legal fees, and paperwork fees. Many of these closing costs are deductible, but not necessarily in the year that you refinance. If you are considering refinancing your mortgage under the current tax rules, however, here are a couple of things to bear in mind. If you refinanced before October 14, 1987, for a longer term than was remaining on the pre-October 14, 1987, loan, you may only deduct the interest paid on the mortgage for the term that was remaining on the old loan. So if you refinanced a loan with 15 years remaining for a 30-year loan with lower payments, you can only deduct the mortgage interest paid on the new loan for 15 years.

The one exception is if you had a balloon mortgage payment come due after October 13, 1987, and you refinanced it to a loan of not more than 30 years; you get the deductibility for the full term of the longer loan. Any refinanced debt you incurred before October 14, 1987, is rolled into your total acquisition indebtedness.

In the past, many homeowners have refinanced mortgages on their appreciating properties to draw on their equity to buy a new car or take a vacation. Under the new tax system, homeowners will no longer have unlimited mortgage interest deductions when drawing on equity. **Any equity debt incurred is subject to a limit of the amount of owner equity**

SECOND MORTGAGES

A second mortgage allows the homeowner to cash in on some of the equity that has built up in the home over time. Some lenders call a second mortgage a "junior lien." Getting a second mortgage is very much like taking out your first mortgage (i.e., you will be required to pay closing costs of 3 percent to 6 percent of the loan value).

You may deduct the interest paid on second mortgages made on or after October 13, 1987, up to the $100,000 limit that had already been reached when the first mortgage was taken out. The amount of second mortgages made before that date is part of your acquisition indebtedness total figure. This means that if you had $50,000 left on your first mortgage as of that date, and had taken out a $25,000 second mortgage on the property prior to October 14, 1987, you would have an acquisition indebtedness of $75,000.

Home Equity Lines of Credit

While the 1986 tax reform called for consumer interest deductibility to be phased out by 1991, interest deductions on equity indebtedness now are limited only by the $100,000 cap. This means that interest paid on home equity lines of credit loans secured by your principal or second home may still be deductible.

Where the traditional second mortgage gives the homeowner money in one lump sum, the home equity line of credit allows homeowners to use the equity in their home like a giant credit card. The lender allows the homeowner to borrow at will against the equity in the home, and charges interest only on the portion of the equity borrowed against. Therefore, your interest deductions for a home equity line of credit depend on whether you borrow against the equity during that year.

Since tax provisions change, check with your tax advisor regarding mortgages deductions.

The Indiana Department of Financial Institutions, Division of Consumer Credit has many other credit related brochures available, such as:

- Answers to Credit Problems
- Applying for Credit
- At Home Shopping Rights
- Bankruptcy Facts
- Buried in Debt
- Car Financing Scams
- Charge Card Fraud
- Choosing A Credit Card
- Co-Signing
- Credit and Divorce
- Credit and Older Consumers
- Deep in Debt?
- Equal Credit Opportunity
- Fair Credit Reporting
- Fair Debt Collection
- Gold Cards
- Hang up on Fraud
- High Rate Mortgages
- Home Equity Credit Lines
- How to Avoid Bankruptcy
- Indiana Uniform Consumer Credit Code
- Look Before you Lease
- Mortgage Loans
- Repossession
- Reverse Mortgage Loans
- Rule of 78s – What is it?
- Scoring for Credit
- Shopping for Credit
- Using Credit Cards
- Variable Rate Credit
- What is a Budget?
- What is the DFI?

Call our toll-free number or write to the address on the cover for a copy of any of the brochures listed or for further consumer credit information.

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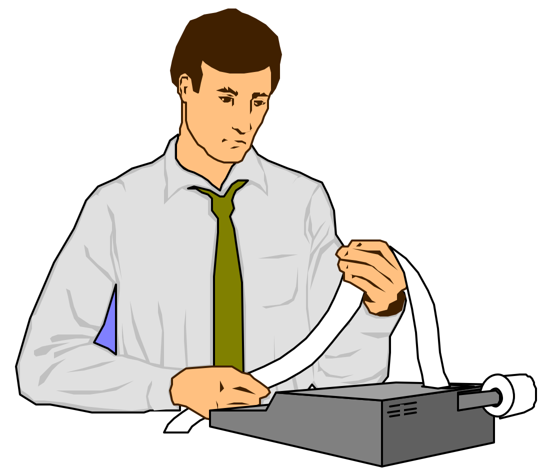
Mortgage Tax Information



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